Marquette Law Review

Volume 19
Issue 2 *February 1935*

Article 5

Bills and Notes: Extensions of Time Doctrine: Renewal Notes: Accommodation Parties

Clifford A. Randall

NOTES

BILLS AND NOTES—EXTENSION OF TIME DOCTRINE—RENEWAL NOTES—ACCOMMODATION PARTIES.—The growth in the volume and complexity of business transactions[1] involving an accommodation party —call him surety, guarantor, endorser or what you will—has been accompanied by a like growth of technical judicial interpretations which purport to define the status and relationship of the parties. A study of the cases reveals at once the increasing difficulties which the courts have experienced in attempting to adjust the rights of the parties by the traditional rules of law. The actual transaction out of which so much litigation on the subject of accommodation parties has arisen seems, at first glance, simple. The imposition of a potential liability upon a third party has been insisted upon by one of the original contracting parties, usually a lender or a vendor selling on credit. Under certain circumstances the potential liability of the third party is to become absolute.

Out of this simple situation, however, has developed a great many variations.[2] It is submitted that this development with its accompanying increase in litigation has produced the abundance of technical definitions interpreting the relationship of the parties. More particularly has it had a tendency to concentrate these technicalities in the cases involving the defenses and discharge of the accommodation party.[3]

One of the most common examples of the simple transaction is the case where the accommodation party signs his name upon a promissory note to enable the borrower to secure a loan from the bank. This situation imports one general idea, namely if the lending bank does not collect the amount of the loan from the borrower at maturity it can collect from the accommodation party. That is elementary law. Vary the transaction, however, by adding two facts. At the time the note was signed none of the parties was quite certain that the loan would be repaid at maturity. When the instrument matured the lending bank renewed the loan in the absence of the accommodation party. Now what is the liability of the accommodation party? The efforts of the courts to interpret his liability have resulted in a great deal of protest and no little confusion.[4] Much of the confusion is attributable to the

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[1] Morgan, *The History and Economics of Suretyship* (1927) 12 Corn. L Q. 153, contains an interesting historical development.

[2] HANNA, CASES AND MATERIALS ON SECURITY (1932) 337 *et. seq.*

[3] Durfee, Book Review (1932) 17 Corn. L. Q. 707. In criticizing ARANT' HANDBOOK OF THE LAW OF SURETYSHIP AND GUARANTY (4th ed. 1932) the writer states, "One notes a lack of proportion, surety's defenses being treated at much greater length than surety's rights and remedies * * *"

[4] In *M. J. Wallrich Land & Lumber Co.* v. *Ebenreiter,* (Wis. 1934) 256 N.W. 753, the stockholders signed their names on the back of the corporations notes following these statements: "Protest waived. Payment guaranteed." The court held the signers were indorsers since if they had not intended to be regarded as such they would not have done the unnecessary act of waiving a right which they did not have, *e.g.,* the right to be served with notice of nonpayment. The court cited Wis. Stat. (1933) § 116.68 which is § 63 of the Uniform Negotiable Instruments Law. But see *Bank of Italy* v. *Symmes,* 118 Cal. App. 716, 5 P. (2d) 956 (1931); *Northern State Bank of Grand Forks* v. *James Bellamy,* 19 N.D. 509, 125 N.W. 888, 31 L.R.A. (N.S.) 149 (1910). *Cf. Vernon Center State Bank* v. *Mangelsen,* 166 Minn. 472, 208 N.W. 186, 48 A.L.R. 710 (1926).

difficulty the courts have had in reconciling the defenses of the accommodation party with the Uniform Negotiable Instruments Law.[5]

Prior to the enactment of the Uniform Negotiable Instruments Law in the various states one who signed a promissory note for the accommodation of another was entitled to be treated as a surety by the holder of the note who had notice of the true relationship of the parties.[6] Whether the accommodation party signed as a *maker or indorser,* an extension of the time for payment granted to the person ultimately liable without the accommodation party's consent discharged him from liability.[7] The Uniform Negotiable Instruments Law affirms this common law rule as to indorsers.[8] There is no agreement on the question whether the Uniform Negotiable Instruments Law abrogated this common law rule as applied to the accommodation party who signed the note as a *co-maker.*[9] Some courts have said that the Uniform Nego-

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[5] The Uniform Negotiable Instrument Law § 119 "A negotiable instrument is discharged:—

1. By payment in due course by or on behalf of the principal debtor.
2. By payment in due course by the party accommodated where the instrument is made or accepted for accommodation.
3. By the intentional cancellation thereof by the holder.
4. By any other act which will discharge a simple contract for payment of money.
5. When the principal debtor becomes the holder of the instrument at or after maturity in his own right.

§ 120 "A person secondarily liable on the instrument is discharged:—

1. By any act which discharges the instrument.
2. By the intentional cancellation of his signature by the holder.
3. By the discharge of the prior party.
4. By a valid tender of payment made by a prior party.
5. By a release of the principal debtor, unless the holder's right of recourse against the party secondarily liable is expressly reserved.
6. By any agreement binding upon the holder to extend the time of payment or to postpone the holder's right to enforce the instrument unless made with the assent of the party secondarily liable, or unless the right of recourse against such party is expressly reserved.

§ 29 "An accommodation party is one who has signed the instrument as maker, drawer, acceptor or indorser, without receiving value therefor and for the purpose of lending his name to some other person. Such a peson is liable on the instrument to a holder for value, notwithstanding such holder at the time of making the instrument knew him to be only an accommodation party.

§ 192 "The person primarily liable on an instrument is the person who by the terms of the instrument is absolutely required to pay the same. All other parties are 'secondarily' liable.

§ 196 "In any case not provided for in this act the rules of the law merchant shall govern.

[6] *Guild* v. *Butler,* 127 Mass. 386 (1879); *McGraw* v. *Union Trust Co.,* 136 Mich. 521, 99 N.W. 758 (1904); *Omaha Nat'l. Bank* v. *Johnson,* 111 Wis. 372, 87 N.W. 237 (1901).

[7] *Uniontown Bank* v. *Mackey,* 140 U.S. 220, 11 Sup. Ct. 844, 35 L.Ed. 485 (1891); *State Bank* v. *Mutual Telephone Co.,* 123 Minn. 314, 143 N.W. 912, Ann. Cas. 1915A 1082 (1913); *Post* v. *Losey,* 111 Ind. 74, 12 N.E. 120, 60 Am. Rep. 677 (1887); *Hamilton* v. *National Bank of Breeden,* 130 Tenn. 465, 171 S.W. 86, L.R.A. 1915C 831; Note (1914) 47 L.R.A. (N.S.) 275.

[8] *National Park Bank* v. *Koehler,* 204 N.Y. 174, 97 N.E. 468 (1912). But *Cf. Night and Day Bank* v. *Rosenbaum,* 191 Mo. App. 559, 177 S.W. 693 (1915).

[9] *Union Trust Co.* v. *McGinty,* 212 Mass. 205, 98 N.E. 679 (1912); *Cellers* v. *Meacham,* 49 Ore. 186, 89 Pac. 426, 10 L.R.A. (N.S.) 129 (1907); *Vanderford* v. *Farmers and Merchants Bank,* 105 Md. 164, 66 Atl. 47, 10 L.R.A. (N.S.)

tiable Instruments Law *requires* that the same obligation be placed upon all makers whether for accommodation or otherwise, namely to pay according to the terms of the instrument.[10] Other courts have refused to accept the idea that the rules of suretyship are incompatible with the Uniform Negotiable Instruments Law, and, applying the former strictly, have permitted the accommodation party who is a co-maker to be discharged where there has been a valid extension of time without his consent.[11] From this it will be seen that the rights and liabilities of the parties as ultimately determined may be considerably different from those intended in the original transaction.[12] Liability may be made to depend on whether the court chooses to apply one technical rule or the other. Thus a stockholder who signs his name on the corporation's note to enable it to secure a loan from the bank may be relying on the fact that the bank will renew the loan as it matures just as it has been doing in its *other transactions with the corporation* over a long period of time. But because nothing is definitely said at the time the original loan is made and the stockholder is not a party to the renewal his liability may ultimately be decided according to the court's inclination to follow either suretyship principles or to designate him *primarily* or *secondarily* liable and strictly apply the provisions of the Uniform Negotiable Instruments Law.

Various explanations have been given for the existence of the doctrine of discharge by extension of time in the field of suretyship. It is said that if the liabilities and rights of the surety are untouched it is fraud on the principal debtor if the one who has given an extension of time proceeds against the surety, thus indirectly violating his agreement with the principal debtor.[13] Also, the contract of the accommodation party has been called collateral to the main contract between the

129 (1907); *Rosendale State Bank* v. *Holland,* 195 Wis. 131, 217 N.W. 645 (1928); *Bosworth* v. *Greiling,* 213 Wis. 443, 250 N.W. 856 (1934) (These cases represent the majority rule). *Contra*: *Fullerton Lumber Co.* v. *Snouffer,* 139 Iowa 176, 117 N.W. 50 (1908); *Meredith* v. *Dibrell,* 127 Tenn. 387, 155 S.W. 163, 46 L.R.A. (N.S.) 92, Ann. Cas. 1914B 1079 (1913) (minority rule).

[10] *Graham* v. *Shepard,* 136 Tenn. 418, 189 S.W. 867, Ann. Cas. 1918E 804 (1916); *Continental Mutual Savings Bank* v. *Elliott,* 166 Wash. 283, 6 P. (2d) 638, 81 A.L.R. 1005 (1932); *Union Trust Co.* v. *McGinty,* 212 Mass. 205, 98 N.E. 679 (1912).

[11] *Fullerton Lumber Co.* v. *Snouffer,* 139 Iowa 176, 117 N.W. 50 (1908); *Smith* v. *Blackford,* 56 S.D. 360, 228 N.W. 466 (1929). "The Negotiable Instruments Law thus adopted neither succeeded nor superseded the provisions of the Code relating to the discharge of a surety from liability by the creditor granting an extension of time to the principal debtor. We hold that a negotiable instrument is discharged as to a surety by an extension of time granted to the principal without the surety's consent, and that such construction is authorized by subdivision 4 of § 1822, [§ 119 (4) of the Uniform Negotiable Instruments Law] which provides that the instrument is discharged by any act which will discharge a simple contract for the payment of money."

[12] Note the language of the court in *Olathe First National Bank* v. *Livermore,* 90 Kan. 395, 133 Pac. 734, 47 L.R.A. (N.S.) 274 (1913), "A stockholder and director of a corporation who signs with the corporation a note given to raise money for its benefit intending to be bound only as a surety is not entitled to the same liberality of treatment that the law affords to *volunteer* sureties; and where the corporation is granted a *valid* extension of time, without his knowledge, he is not thereby released from liability unless he suffers some injury therefrom." The statement evidences a willingness to cut through the rules and make the problem one of construction of the business transaction.

[13] 2 WILLISTON, CONTRACTS (2d ed. 1930) § 1225, 2233-2234.

creditor and debtor and it has been reasoned out of this definition that the termination of the main contract *dissolves* the collateral agreement and excuses the surety.[14] A traditional explanation is that the extension of time by contract abridges or impairs the surety's right to pay the debt at maturity and to be subrogated to the creditor.[15] Such reasoning applied in the cases to justify the escape of the accommodation party is often mere rationalization.

Of what value is the right of subrogation to the stockholder who has signed the corporation's note as an accommodation where the corporation is insolvent? May not the extension of time actually be a benefit to the stockholder where it allows the corporation the use of the capital to finance a transaction which may ultimately mean the difference between a surplus and a deficit at the end of the period of extension? It is submitted that an injury to the surety less theoretical should be a requisite showing to permit a discharge on the grounds of extension of time.[16]

Where the discharge of the accommodation party is *actually justifiable* under the rules of suretyship, to deprive him of this right of discharge by judicial interpretation of the Uniform Negotiable Instruments Law seems unnecessarily harsh.[17] It does seem that the act can be applied fairly without such interpretation.[18] It is admitted in decisions supporting the view that suretyship defenses are abrogated by the Uniform Negotiable Instruments Law that the act is not a complete codification of the entire law on the subject.[19] Any case not provided for in the act is said to be governed by the law merchant.[20] The subject is not clarified, however, by the prevailing abundance of varied and contradictory impressions of just what the "law merchant" actually means.[21] Furthermore the reasons used by the courts to exclude surety-

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[14] ARANT, HANDBOOK OF THE LAW OF SURETYSHIP AND GUARANTY (4th ed. 1932) 286.

[15] *Benson* v. *Phipps*, 87 Tex. 578, 29 S.W. 1061, 47 Am. St. Rep. 128 (1895); *First Nat'l. Bank of Cumberland* v. *Parsons*, 45 W.Va. 688, 32 S.E. 271 (1898).

[16] "But extension of time is never granted in general. It is always granted under particular circumstances and the circumstances are important. If a creditor should extend time capriciously that would be one thing; if he extends time because the principal refuses to pay and the creditor reasonably believes that he cannot be forced to pay that is another thing; if to the circumstance last put we should add the not uncommon one of security obtained as the price of the extension that is yet another thing. I assume that extension of time without reason is uncommon practice, but that when the circumstance makes it reasonable, extension of time is common indeed. And I believe that a court would be justified in making such assumptions by virtue of its judicial knowledge of human behavior." Durfee, Book Review (1932) 17 Corn. L. Q. 707.

[17] (1928) 42 Harv. L. Rev. 136.

[18] "The decisions are at variance with well established doctrines of suretyship. §§ 119 and 120 of the Negotiable Instruments Law do not require them. The discharge of a party, who, though primarily liable, is known to the holder to be a surety, by giving time to the principal debtor seems to be covered by § 119 (4). But if this is not so, then, since the discharge of a surety-maker or surety-acceptor by an extension of time granted to the principal by the holder with knowledge of the relation, is neither a discharge of the instrument nor a discharge of the party secondarily liable, this should be regarded as an omitted case and therefore to be governed by the law merchant under § 196." BRANNAN'S, THE NEGOTIABLE INSTRUMENTS LAW (5th ed. 1932) 884.

[19] *Union Trust Co.* v. *McGinty*, 212 Mass. 205, 98 N.E. 679 (1912).

[20] Uniform Negotiable Instruments Law § 196. Cited n. 5 *supra*.

[21] Note (1916) 30 Harv. L. Rev. 141; Note (1925) 38 Harv. L. Rev. 954.

ship defenses under the Uniform Negotiable Instruments Law are all open to attack.[22] It can hardly be said that the act has produced uniformity.[23] Does any *actual* impairment of negotiability result from the application of the rules of suretyship? Unless the holder of the note *knows* of the relation between the principal debtor and the accommodation signer when he extends the time the rule does not apply.[24] It must be admitted that commercial necessity demands an almost automatic application of the Uniform Negotiable Instruments Law. At least the application must be automatic enough to permit decisions which, in the absence of the act, would seem arbitrary. It must be admitted also that the right of the accommodation party which is sought to be protected by the suretyship rule as to extension of time is often more imaginary than real. It is submitted however that rights should not be sacrificed to a mere game of legal rules.[25] They should be controlled if uniformity or commercial necessity requires by a more clearly defined legislative definition of the application of the Uniform Negotiable Instruments Law to accommodation parties specifically.[26]

There can seldom be any doubt that the taking of the renewal note by the lender at the maturity of the first note is an extension of the time for payment. Under the suretyship rule the taking of such renewal note without the consent of the accommodation party should discharge him.[27] Under the Uniform Negotiable Instruments Law the accommodation *indorser* should be discharged in this situation.[28] The problem is often confused, however, with the question of whether or not the taking of the renewal note discharges the prior *obligation* as to those parties who did not sign the renewal.[29] Cases where this problem arises usually involve a lending bank.[30] The bank is under compulsion to keep

[22] BRANNAN'S, THE NEGOTIABLE INSTRUMENTS LAW (5th ed. 1932) 884 (criticizes the contention that the Act provides the exclusive methods of discharge).

[23] Courts holding the minority point of view on the subject have held that a discharge of the co-maker on the grounds of extension of time without his consent is authorized by § 119 (4) of the Act. *Citizens State Bank of Colman* v. *Rosenwald* (S.D. 1934) 256 N.W. 264; *Tatum* v. *Commercial Bank & Trust Co.*, 193 Ala. 120, 69 So. 508 (1915); *Hardin Trust Co.* v. *Wollard,* 119 Neb. 307, 228 N.W. 866 (1930).

[24] BRANNAN'S, THE NEGOTIABLE INSTRUMENTS LAW (5th ed. 1932) 887.

[25] See *Building Engineering Co.* v. *Northern Bank,* 206 N.Y. 400, 99 N.E. 1044 (1912); *Knoffle* v. *Knoxville Banking and Trust Co.,* 128 Tenn. 181, 159 S.W. 838 (1913).

[26] See the proposed amendments to §§ 119 and 120 of the Uniform Negotiable Instruments Law in, Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings (1931), 231-234.

[27] *Citizens State Bank of Colman* v. *Rosenwald,* (S.D. 1934) 256 N.W. 264. Cited n. 23, *supra.*

[28] *e.g.* Under § 120 (4) of the Act. But *cf. Night and Day Bank* v. *Rosenbaum,* 191 Mo. App. 559, 177 S.W. 693 (1915); *Farmers State Bank of Lisbon* v. *Fausett,* 54 N.D. 696, 210 N.W. 638, 48 A.L.R. 1819 (1926). In the latter case there were two *demand* notes, the one taken as a renewal of the other. The situation appears rather unusual. The court held that the renewal note did not discharge persons secondarily liable.

[29] *West Madison State Bank* v. *Mudd,* 250 Ill. App. 258 (1929). But see *Bank of U. S.* v. *Chemical Bank and Trust Co.,* 246 N.Y. Supp. 595 (1930).

[30] The individual lender is seldom conscious of any necessity for keeping the note up to date. If the borrower is unable to pay when the note is due there is no advantage for him in renewing the note and giving up the present right to bring an action on the defaulted instrument. If the lender does take a renewal it becomes important to consider what has happened to the old note, whether or not there has been consideration for the renewal and what, specifically, the parties intended to do by the transaction.

the debt identified by an instrument which is current and which will satisfy the requirements of the bank examiner. That is, the bank must replace the past due note with one that evidences a claim not yet matured. This is accomplished by a bookkeeping transaction.[31] It is submitted that this bookkeeping transaction often influences courts in their determination of the accommodation party's liability.[32] The original note is said to be "paid."[33] Paid in what? One promise has been substituted for another.[34] Where the bank has cancelled the first note and surrendered it, certainly the note is extinguished but not the debt.[35] It is at best an artificial sort of transaction, not one upon which to decide the liability of a party to a contract. When to this artificiality is added technical considerations of whether the accommodation party is in a "primary" or "secondary" position under the terms of the Uniform Negotiable Instruments Law and of whether the rules of suretyship affect him in the position in which he is placed, it becomes apparent that the status of the parties as intended under the original contract may well become lost in the maze of legal refinements. It is submitted that where the principal borrower and the lender have subsequently acted with respect to the original contract without the knowledge and consent of the accommodation party the pertinent inquiry should be: have they acted in such a way as to prejudice a right which the accommodation party did reserve in fact under the terms of the original contract?

The lending bank can always eliminate the possibility of the accommodation party's escape by granting a *qualified* extension only.[36] That is, the bank may expressly reserve the right to hold the accommodation party. But no adequate statement can be made of what, exactly, constitutes such *express* reservation.[37] It may be a matter of evidence.[38] The retention of the original note marked as collateral for the renewal

[31] The first note is marked "Cancelled-Renewal" or perhaps "paid" and then surrendered to the principal borrower. It may also be marked "Collateral" and held by the bank. The banks records then show the original debt as having been satisfied and another debt for a like amount as having been incurred by the principal borrower. All the principal borrower has done is to affix his signature to another instrument. He may or may not have paid interest.

[32] *Marine Bank of Newport News* v. *McMurran,* 138 Va. 657, 123 S.E. 507 (1924). The defendant bank discounted the note for the plaintiff bank. The latter guaranteed payment. The defendant bank renewed the note without the knowledge or consent of the plaintiff bank. Held, the first note was discharged as was the plaintiff-guaranteeing bank. See *National Park Bank* v. *Koehler,* 204 N.Y. 174, 97 N.E. 468 (1912).

[33] *Trego* v. *Cunningham's Estate,* 267 Ill. 367, 108 N.E. 350 (1915); *Citizen's Commercial & Savings Bank* v. *Platt,* 135 Mich. 267, 97 N.W. 694 (1903); But *cf. Spear* v. *Olson,* 104 Neb. 139, 175 N.W. 1012 (1920); *Lawrey* v. *Milwaukee Nat'l. Bank,* 114 Wis. 311, 90 N.W. 178 (1902).

[34] *Beech and Fuller Co.* v. *Lane,* 75 Ind. App. 184, 129 N.E. 52 (1920) where the maker of a note asked the payee to renew and some of the sureties on the original signed the renewal note it was held that the new note was a *renewal* of the old one although the bank marked the old note *paid.*

[35] It was said in *Haley* v. *Austin,* 74 Colo. 571, 233 Pac. 43 (1924) that a note given in renewal for another note does not extinguish nor in any way change the original debt except by postponing the time for payment. Query: Would the court have taken the same view if the lender had been a bank instead of a private individual.

[36] *Night and Day Bank* v. *Rosenbaum,* 191 Mo. App. 559, 177 S.W. 693 (1915).

[37] *National Park Bank* v. *Koehler,* 204 N.Y. 174, 97 N.E. 468 (1912) represents the extreme requirement.

[38] *Miners and Merchants Bank* v. *Rogers,* 123 Mo. App. 569, 100 S.W. 534 (1907).

should be a sufficient reservation.[39] It does not seem that the addition of the *actual words* of reservation on the old note should be essential to enable the bank to controvert the accommodation party's defense. But it has been held that the retention of the note is not enough.[40] This appears to be a sacrifice of substance to form. In view of the judicial notice taken of the bookkeeping transaction itself the courts should also recognize that the retention in the bank's files of the past due note whether marked "collateral" or not can only be for purposes of security. This note has no security value "per se" in the sense that other collateral securities have value. What other security can it give than a right to proceed against the parties whose names appear on it and not on the renewal note? The judicial attitude on this subject is but a further revelation of how technical the law tends to become on almost every aspect of this problem.

CLIFFORD A. RANDALL.

FIRE INSURANCE—CLAUSE AGAINST CHATTEL MORTGAGES—EFFECT OF VOID CHATTEL MORTGAGE AS MORAL HAZARD.—The standard fire insurance policy for Wisconsin[1] contains a provision that the insurer shall not be liable for loss or damage to any personal property covered by the policy while encumbered by a chattel mortgage unless otherwise provided by agreement.[2] In the case of *Mielke* v. *National Reserve Ins. Co.*[3] the insurance company, contending that the insured had placed a chattel mortgage on some of the property covered by the policy, sought to have that property excluded from the protection of the policy. The insured countered with the contention that the chattel mortgage was ineffective and void[4] and that therefore the provision was not applicable. While the court found that the chattel mortgage was effective at the time of loss and that therefore the property included therein was excluded from the protection of the policy, it further added that, if it had been obliged to hold the chattel mortgage ineffective and void, the property described in the instrument would,

[39] But see *Citizens State Bank of Colman* v. *Rosenwald,* (S.D. 1934) 256 N.W. 264. "The reservation of rights against the surety must be express and definite however, and the creditor must not only retain the original instrument of indebtedness but must expressly reserve the right of immediate action *thereon* at least against the surety."

[40] *National Park Bank* v. *Koehler,* 204 N.Y. 174, 97 N.E. 468 (1912); *Citizens State Bank of Colman* v. *Rosenwald,* (S.D. 1934) 256 N.W. 264. Cited n. 39 *supra.*

[1] Wis. Stats. (1933) § 203.01.

[2] Wis. Stats. (1933) § 203.01 lines 62 to 67 inclusive, "unless otherwise provided by agreement * * * this company shall not be liable for loss or damage to any property insured hereunder while incumbered by a chattel mortgage * * *."

[3] (Wis. 1934) 256 N.W. 776.

[4] The chattel mortgage covered property which would have been subject to exemption if such exemption had been claimed and the mortgagor's wife not having joined in the mortgage would have the right to claim such exemption. Since she had not claimed such exemption (and she had no reason to do so) before the time of the fire loss the court decided that the mortgage was effective to all the property covered thereby.